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Before the
FEDERAL COMMUNICATIONS COMMISSION
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In the Matter of	
Access Charge Reform	CC Docket No. 96-262
Price Cap Performance Review for Local Exchange Carriers	CC Docket No. 94-1
Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers	CCB/CPD File No. 98-63
Petition of U S West Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA	CC Docket No. 98-157

AT&T REPLY COMMENTS ON LEC PRICING FLEXIBILITY FNPRM

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SUMMARY

In these reply comments, AT&T responds to other parties' comments on the Commission's FNPRM on issues related to price cap LECs' common line and traffic-sensitive services: geographic rate deaveraging, Phase II pricing flexibility, and modifications to the price cap formulas for the baskets containing those services. AT&T also addresses other parties' comments on the FNPRM's proposals on constraining CLEC access charges.

In Section I, AT&T shows that although the LECs contend that they should be permitted to deaverage their common line and traffic-sensitive access charges without a competitive showing, their comments nonetheless recognize, and indeed confirm, that the safeguards proposed by AT&T are necessary and appropriate. Thus, the Commission should not allow the LECs to deaverage their common line rates unless IXCs are granted 254(g) forbearance, the CCLC, PICCs and ILEC Flowback are eliminated, all remaining carrier access charges are set at forward-looking economic cost in the study area, and deaveraged UNE loops are available in the study area where deaveraging relief is requested. Once these preconditions are met, the FCC should permit common line deaveraging using a straightforward adaptation of the FCC's universal service cost proxy model to develop the costs for each UNE zone. As GTE (at 13) explains, "use of different zones for USF, UNE loops and SLC could lead to a competitive imbalance and uneconomic arbitrage and therefore should be avoided." The solution is to require carriers to use the same zones for UNE loop, USF and common line access price deaveraging. The Commission should not permit deaveraging of traffic-sensitive elements (local switching and tandem switching), because, as even the LECs admit, there is no clear evidence to suggest that the costs of these elements vary geographically within a study area.

As demonstrated in Section II, many parties oppose even establishing Phase II triggers for switched services at this time. As MCI (at 7) explains, "[t]o date there has not been even the slightest indication that competitive entry will begin to constrain price cap rates for these services in the foreseeable future." Certainly the LECs' proposal that Phase II relief is appropriate when competitors offer common line and traffic-sensitive services to 50% of customers locations or locations representing 65% of the LEC's revenues for these services in an MSA is wholly inadequate to determine whether competition has evolved to discipline switched access pricing. For one, merely "offering" service does not test for the presence of *actual* competition. In addition, it does not test for *prerequisites* to competition, such as whether the LEC is provisioning unbundled elements, "quickly, at economic cost, and in adequate quantities." Accordingly, it is essential that the Commission adopt an appropriate test. In addition to the preconditions for common line deaveraging having been met, Phase II relief should not be granted for common line and traffic-sensitive services in an MSA until facilities-based competitors offer the services for which the LEC seeks regulatory relief at a price and quality comparable to that of the LEC; competitors' services are available to 75% of subscriber locations and 50% of subscriber locations are actually served by such alternate facilities-based providers. Facilities-based competitors must have sufficient capacity to absorb substantial amounts of LEC traffic in the event of a significant non-transitory price increase.

AT&T shows, in Section III, that there is virtually unanimous consensus among the commenters the Commission should not require LECs to develop a capacity-based rate structure for local switching. As the parties explain, such a rate structure is another form of traffic-sensitive recovery, and it is not clear that payments associated with trunk-based charges would differ much from those based on existing per-minute charges. Because IXCs

order trunks based on their own peak period traffic, which comprises only a small portion of overall LEC traffic and whose peak may differ from that of the LEC's traffic, a capacity-based charge would not capture peak demand any better than a per-minute charge. Wisconsin (at 5) explains, "the theoretical attraction of capacity pricing is heavily burdened with practical problems. . . ." Working with the industry, Wisconsin attempted to "devise a workable capacity-based access charge regime. In the end, . . . implementation proved impossible." As the LECs themselves show at some length, a capacity-based structure is likely to have substantial and costly implementation issues and is not likely to result in an efficient, cost-causative outcome. In these circumstances, there is simply no rational basis for the Commission to allow the LECs to deviate from the current switching rate structure.

As discussed in Section IV.A, the LECs' contention that the effect of growth in traffic volumes is already fully reflected in the X-Factor, so that neither the Commission's proposed q factor or full g factor adjustments are warranted, is without merit because it ignores fundamental weaknesses in the Commission's TFP/X-Factor analysis and framework. The q factor and full g factor are necessary because a single X-Factor based on total company productivity growth does not take into account significant differences in the cost/productivity trends among different services and, in particular, the higher productivity associated with interstate access. In addition to the shortcomings of the X-Factor, the fact that the Commission targeted $400 million of access reductions to the TIC instead of traffic-sensitive rates has meant that the rates for other services are more inflated than they would have been had the downward impact of the X-Factor operated to control them.

As shown in Section IV.B, the FCC's concerns about whether the g factor, as well as the multiline business PICC, generate the appropriate amount of revenue can be addressed by capping common line rates on a revenue per line basis, thereby permitting "common line

revenue to increase with the average growth rate of all common lines." FNPRM, ¶ 233. Contrary to the LECs' contention, the TFP/X-Factor does not make use of a full g unnecessary because the TFP approach to calculate the X-Factor does not properly reflect declining common line costs per minute that result from the combination of substantial growth in minutes and the recovery of non-traffic-sensitive costs on a per-minute basis. Moreover, the current g/2 formula confers an unwarranted windfall on those LECs that still charge the CCLC, which generally tend to be the LECs with the highest interstate access rates. All price cap LECs, however, should be required to recompute their common line PCIs assuming that a full g had been in place since the start of price cap regulation. As MCI (at 16) points out, "it is more important for the Commission to correct for the effects of past use of g/2 in the common line PCI formula" than adopt a full g in future tariff filings for those few LECs that still have significant CCL revenue. Because multiline business lines are growing faster than the primary residential and single-line business lines that receive a subsidy via the multiline business PICC, LECs have reaped a substantial windfall since January 1, 1998. With a revenue per line cap, the amount of revenue obtained from subsidy elements – i.e., the multiline business PICC and CCLC – is equal to the shortfall in revenue per line collected from the lines receiving the subsidy. As shown in Section IV.C, the LECs should also be required to reduce their PCIs to the levels that would have resulted had the FCC incorporated a q factor in the traffic-sensitive and full g factor in the common line PCI formulas at the inception of price caps.

As shown in Section V.A, the Commission should adopt the BLS chain-weighted GDP-PI in order to eliminate the inconsistency between calculation of the X-Factor and application of the GDP-PI in the PCI formula. In Section V.B., AT&T shows that USTA's

and U S WEST's proposals for major changes in the price cap structure are unwarranted, premature and beyond the scope of this proceeding.

As discussed in Section VI, AT&T showed in its comments that the Commission's objective of fostering marketplace constraints on CLEC access rates will best be served by encouraging CLECs permissively to detariff access rates that exceed the levels of the ILECs in the same service area, and instead to contract with IXCs upon mutually agreeable terms, by requiring CLECs to provide full cost support for such supracompetitive rates in nonstreamlined tariff review proceedings. No commenter provides a showing that IXCs may lawfully be required to order and pay for service from a CLEC unless the IXC voluntarily agrees to do so. Moreover, none of the "solutions" that these parties espouse, such as Commission prescription of "benchmark" access rates, mandating equal originating and terminating access rate levels, or remitting IXCs to the formal complaint process to challenge excessive (and unordered) CLEC access rates would be effective in alleviating the problem of exorbitant CLEC access rates, and all of these alternatives are facially inconsistent with the Commission's market-based policies for controlling access rates.

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AT&T REPLY COMMENTS ON LEC PRICING FLEXIBILITY FNPRM

Pursuant to the Commission's Fifth Report and Order and Further Notice of Proposed Rulemaking, FCC 99-206, released August 27, 1999 in the above proceedings ("Fifth Report" and "FNPRM," respectively), and Section 1.415 of its rules, AT&T Corp. ("AT&T") submits these reply comments on the Commission's proposals to: (1) allow geographic deaveraging of common line and traffic-sensitive access charges by incumbent price cap local exchange carriers ("LECs" or "ILECs"); (2) define the triggers and relief for Phase II pricing flexibility for switched services; (3) modify the rate structure for local switching and the price cap formula for the traffic-sensitive basket; (4) revise the price cap mechanism for the common line basket and make other modifications to price caps; and (5) adopt rules to address the

failure of market forces to constrain competitive local exchange carrier ("CLEC") access charges.[1]

Given its numerous public interest benefits, AT&T strongly supports the CALLS proposal and urges the Commission to adopt it for *all* price cap LECs.[2] If the Commission does so, the CALLS proposal would resolve, in an equitable and sustainable manner, many of the issues raised in the FNPRM.

I. GEOGRAPHIC RATE DEAVERAGING FOR SWITCHED ACCESS SERVICES SHOULD NOT BE PERMITTED WITHOUT CERTAIN COMPETITIVE PREREQUISITES HAVING BEEN MET.

AT&T (at 3-8) showed that geographic deaveraging of common line elements should not be permitted unless IXCs are granted section 254(g) forbearance, the carrier common line charge ("CCLC"), presubscribed interexchange carrier charges ("PICCs"), and ILEC Flowback are eliminated from carrier access charges, and remaining carrier access charges are set at forward-looking economic cost. Unbundled network element ("UNE") loops must be available on a deaveraged basis throughout the study area where deaveraging relief is requested by the LEC.[3] Absent these conditions, deaveraging would allow the LECs to employ anticompetitive tactics – specifically, cross-subsidization – in markets where

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1 A list of parties filing comments and the abbreviations used to identify them herein can be found in Attachment A.

2 Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Low-Volume Long Distance Users, and Federal-State Joint Board on Universal Service, CC Docket Nos. 96-262, 94-1, 99-249 and 96-45, Notice of Proposed Rulemaking, FCC 99-235, released September 15, 1999 (requesting comments on the CALLS proposal).

3 The availability of deaveraged UNEs is mandated by the Commission's local competition rules, irrespective of any pricing flexibility granted to the LEC. 47 C.F.R. 507(f). The Commission has lifted the stay of its deaveraged UNE rule effective May 1, 2000. See Federal-State Joint Board on Universal Service Reform, CC Docket No. 96-45, Ninth Report & Order and Eighteenth Order on Reconsideration, FCC 99-306, released November 2, 1999, ¶¶ 119-120.

sufficient competition to provide exchange access discipline has not yet developed. *(See Section II for the Phase II triggers).*

Although the price caps LECs contend that they should be permitted to deavearge their common line and traffic-sensitive switched access charges without a competitive showing (Bell Atlantic at 19-21; BellSouth at 3; GTE at 6; SBC at 1-2; USTA at 3-4; U S WEST at 1-7), their comments nonetheless recognize, and indeed confirm, that the safeguards proposed by AT&T are necessary and appropriate.

As to 254(g) relief, if competitive conditions mandate common line deaveraging, it is equally true that IXCs cannot hope to compete in a national long distance market when pitted against carriers with lower overall access costs. As U S WEST (at 6) explains, if "a LEC is not permitted to deaverage, it will not be able to meet . . . competition. As competitive providers take advantage of this easy arbitrage opportunity, the LEC, with its averaged rates, will rapidly lose customers in low-cost areas (where the averaged rates are significantly higher than costs) while continuing to serve its customers in high-cost areas (where averaged rates are significantly below costs). The predictable end result of this skewed regulatory scheme will be . . . denial of competitive benefits to consumers." These facts are even more compelling in the interexhange market with its low entry barriers. Wisconsin (at 2) confirms this: "The FCC should carefully consider the extent to which de-averaged access rates will result in significant differences in the costs of originating and terminating toll calls in more rural areas. If the cost is significantly greater, long distance providers terminating calls in those regions, but offering service across all regions at uniform prices, will be unable to compete with providers operating solely in low-priced urban areas. These providers will be able to continue to compete and to service these areas only if they are able to de-average toll rates to reflect these cost differences. The only other viable alternative for providers that wish

to remain competitive in the face of significantly higher rural access costs, would be to avoid rural areas as much as possible."[4]

Yet, some parties, based on their own parochial interests, argue that 254(g) forbearance should not be granted to interexchange carriers ("IXCs"). Alaska at 2-4; Hawaii at 2; NRTA at 8; NTCA at 8; RICA at 14-15. They are wrong. Indeed, the ultimate result of a failure to grant section 254(g) forbearance will be that national carriers will be unable to compete with lower cost regional carriers, will lose share in low-cost markets, and their averaged rates will therefore rise because of disproportionate amounts of traffic in high-cost areas. Instead of forcing this anti-consumer result, the Commission should expressly allow IXCs to deavearge their rates, so that they may remain competitive on a national scale. If this forces interexchange rates to rise in high-cost areas to an unacceptable degree, the Commission should address that fact by an access-related universal service fund ("USF"). Wisconsin at 2.

As to AT&T's other conditions, the LECs generally recognize that these are appropriate conditions. For example, Bell Atlantic (at 19-20), BellSouth (at 3-5) and Sprint (at 3) expressly allude to the CALLS proposal which, in addition to other safeguards, would link geographic deaveraging of common line charges to the establishment of UNE zones and elimination of PICCs and CCLCs from carrier-paid access charges. Indeed, USTA (at 4) also confirms that UNE deaveraging is an appropriate pre-condition because "as network elements are deaveraged, it becomes imperative to permit [common line rate] deaveraging so as to provide optimal levels of network element and facilities-based competition." As to elimination of PICCs and CCLCs, USTA (at 8) reminds the Commission that it has

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[4] See also NRTA at 4 (asking the Commission to refrain from further increased access deaveraging given full knowledge of threat that it poses to geographically averaged toll

(footnote continued on following page)

previously recommended "that nonrural carriers recover their common line costs from the end user." See also BellSouth at 3-4; GSA at 4; MCI at 3-6; Sprint at 3.

Further, as AT&T showed, the remaining carrier-paid access rate elements must be set at forward-looking economic cost to avoid the cost/price squeeze created by excessive LEC access rates. AT&T at 5-6; MCI at 9. Most directly, excess access rates confer a tremendous strategic advantage, particularly as the LECs contemplate in-region entry into long distance services. Given that the LECs are both competitors and suppliers of IXCs in certain markets (and of competitive access providers ("CAPs") in many more markets), LECs have the opportunity to 'price squeeze' their competitors by continuing to charge high prices for bottleneck services and lowering price in competitive downstream markets.[5] To the extent that access charges exceed economic costs, a LEC faces a lower cost of providing long distance services than competitors who must pay excessive exchange access charges. Thus, prior to deaveraging of common line rates, it is critical that all carrier-paid access charges in the study area be set at efficient, forward-looking economic cost.

Once all of these conditions are met, and the LEC has made available deaveraged UNEs in the study area where deaveraging relief is sought, the Commission should permit, but not require, a LEC to deaverage its common line rates. AT&T at 6; Bell Atlantic at 19; BellSouth at 3; USTA at 6; U S WEST at 8. AT&T (at 6) showed that the Commission's forward-looking cost proxy model that is being developed in the Universal Service proceedings, CC Dockets 96-45 and 97-160, should be modified as appropriate and used to develop common line costs for the UNE zones in a study area.

(footnote continued from previous page)

rates).

5 Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd 6786, ¶ 19 (1990) ("LEC Price Cap Order").

Like AT&T, USTA (at 6) also "supports the use of UNE zones as the geographic basis for common line deaveraging." Contrary to the suggestions of BellSouth (at 3-5) and U S WEST (at 3-4), the Commission should not permit LECs to define their own common line zones without a cost showing. As GTE (at 13) explains, "use of different zones for USF, UNE loops and SLC could lead to a competitive imbalance and uneconomic arbitrage and therefore should be avoided." For example,"[i]f different zones are set for the USF and common line rates, universal service funding may not align with costs. Common line costs in a non-high-cost zone may overlap a USF high-cost zone, resulting in USF funding for a region not in need of support. This mistargeting of funds would again result in an implicit subsidy in violation of section 254(e) of the Act." GTE at 14. The solution is to require carriers to use the same zones for UNE loop, USF and common line access price deaveraging. Moreover, as USTA (at 6) recognizes, use of trunking zones to deaverage common line rates would be inappropriate because "trunking basket zones . . . generally have little correlation to the way common line costs are incurred."

There is also support for the fact that deaveraging of common line rates should not be predicated on *current* SLC caps (FNPRM, ¶ 194). AT&T at 7; GTE at 16-17; USTA at 6-7. USTA notes that it "supports increases in SLC caps to reduce implicit support for nonrural LECs. Ideally, the ultimate SLC caps should be set to more closely align with the interstate common line costs of the end user (including Marketing expense). If necessary, a transition period could be used to arrive at the ultimate amount. End users would pay the lower of the deaveraged SLC or the cap. If the end user's deaveraged SLC is greater than the ultimate SLC cap, the federal universal service fund would pay explicit support equal to the difference between the deaveraged SLC and the ultimate SLC cap to the eligible telecommunications carrier serving the end user. Deaveraging the SLC without raising the SLC cap about the current level will simply increase the size of the universal service fund." Accordingly, as

AT&T had suggested, SLC rates should be permitted to increase to the extent necessary for the SLC in any given zone to recover fully the interstate-assigned portion of the loop, line ports and retail marketing expense.

As AT&T explained (at 7-8), the Commission should not permit deaveraging of the traffic-sensitive access elements, namely, local switching and tandem switching. There is no evidence to suggest that the costs of these elements vary geographically within a study area,[6] and even the LECs concede that "switching costs are not as affected by geography as common line." Bell Atlantic at 20; BellSouth at 5; USTA at 8. As Time Warner (at 31) explains, deaveraging of switching would simply allow the LECs to drop rates in areas where they face competition and raise rates elsewhere despite the fact that there are no real geographic cost differences. Thus, unless the states find some cost-based justification for geographic deaveraging of these elements (and generally they have not), there would be no predicate for, and the FCC should not permit, any deaveraging of equivalent exchange access elements because it would create undesirable arbitrage opportunities that would distort customer usage and investment decisions. AT&T at 7-8.

II. A LEC MUST BE REQUIRED TO SATISFY A MEANINGFUL COMPETITIVE TEST BEFORE IT IS ALLOWED PHASE II PRICING FLEXIBILITY FOR SWITCHED SERVICES.

Predictably, the LECs clamor for pricing flexibility for switched services and suggest a very lenient test, similar to that adopted in the Fifth Report. The LECs uniformly contend that Phase II relief, which would remove their common line and traffic-sensitive services from

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[6] Time Warner at 3 *citing* Federal-State Joint Board on Universal Service, Recommended Decision, 12 FCC Rcd 87, ¶¶ 234-35 (1996) (citing evidence that switching costs do not vary by switch size); see also Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board, Notice of Proposed Rulemaking and Notice of Inquiry, 10 FCC Rcd 12309, ¶ 10 (1995); MCI at 3.

price cap regulation and the Part 69 access charge rules, is appropriate when competitors offer such services to 50% of customer locations or locations representing 65% of the LEC's revenues for those services in a metropolitan serving area ("MSA"). Bell Atlantic at 21-22; BellSouth at 6; GTE at 22-24; SBC at 2; USTA at 9-10. Some LECs even suggest that these triggers could be met on a "class of customer" basis to accelerate their ability to meet the trigger. GTE at 22-24; USTA at 9-10. Bell Atlantic (at 23) additionally suggests that once an ILEC has met these Phase II triggers in areas representing 85% of its total revenues, then it should be permitted to remove all of its services from price caps throughout its region. All of these contentions should be rejected.

First, a number of parties oppose even establishing Phase II triggers for switched services at this time. As MCI explains, "[t]o date there has not been even the slightest indication that competitive entry will begin to constrain price cap rates for these services in the forseeable future. Without exception, every price cap LEC is pricing its common line and traffic-sensitive services at the maximum permitted by the price cap rules." MCI at 7. Sprint opposes Phase II relief until there is real evidence of need for switched service pricing flexibility. Sprint explains (at 4, 8) that ILECs and CLECs compete for end users and that an ILEC has no incentive to reduce access charges. Rather, its incentive is to charge end users as little as possible and exploit its access bottleneck. C&W USA (at 7) confirms that "[i]n light of the inability of the marketplace to achieve significant reductions in access charges, [there is] no reason why price cap ILECs should be relieved of . . . regulatory requirements that restrain access prices at this time." It also suggests that the Commission needs to gain "real world" experience with Phase I relief first.

Although AT&T does not disagree with these observations, it is not opposed to establishing an appropriately crafted Phase II test now that would not relieve LECs prematurely of price cap and rate structure constraints before competition has evolved to

discipline switched access pricing. The test proposed by the LECs is wholly inadequate for this purpose. For one, it does not test for the presence of *actual* competition. Time Warner (at 25) explains that the mere "offering" of services is inadequate evidence that competitors can compete effectively with the incumbent LEC. Moreover, these triggers do not test even for the *prerequisites* of competition, for example, whether the LEC is providing "unbundled network elements 'quickly, at economic cost, and in adequate quantities' – three key assumptions underlying the Commission's theory that ILEC access rates would be constrained by IXC self-supply of access." MCI at 9. As MCI (at 9) shows, the price squeeze problem would be magnified dramatically if price cap constraints were removed prematurely. Thus, a rigorous competitive test is not only necessary, but *essential.*

AT&T has suggested an appropriate test. AT&T (at 8-12) showed that LECs should not be granted Phase II relief for common line and traffic-sensitive services until facilities-based competition exists for each component of access for which relief is sought throughout a MSA. Specifically, facilities-based competitor(s) must offer those services at a price comparable to the LEC's price cap rate and at a level of quality comparable to that of the LEC. Such competitive services must be available to 75% of subscriber locations in the MSA, and 50% of subscriber locations in the MSA must actually be served by such alternate facilities-based providers.[7] GSA (at 8) agrees with AT&T that 50% of customer locations must be served by competitive facilities before Phase II relief is granted. Facilities-based competitors must have sufficient capacity to absorb substantial amounts of the LEC's business in the event of a small but significant non-transitory price increase. Data used to measure

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[7] Contrary to Bell Atlantic's (at 23) and GTE's (at 25) suggestion, the Commission should exclude mobile wireless service from the Phase II trigger because wireless service is not a substitute for local landline telephony. Sprint at 9; AT&T at 10-11.

competition should be drawn from sources that are reliable and verifiable by an independent third party. In addition, all of the preconditions cited above in Section I for common line deaveraging in a study area (namely, 254(g) forbearance; elimination of CCLC, PICCs, ILEC Flowback; all remaining carrier-paid access rate elements priced at forward-looking economic cost; and deaveraged UNE loops available) must exist before Phase II relief is granted for an MSA within that study area.

Although the Commission has previously expressed concern about its ability to obtain necessary data (Fifth Report, ¶ 103), AT&T has now proposed a workable method of identifying the number of locations served by competitors. As AT&T (at 10) explained, the LEC should provide the data relating to the number of subscribers it serves using its own common line and switching facilities as well as the number of UNE loops that it has provided to other carriers that do not use LEC switching facilities. The Commission should also require any incumbent LEC that is providing local service outside of its own franchise area to provide these data. AT&T commits that it will provide, on a confidential treatment basis, the data regarding the number of customer locations it serves via cable facilities, and it believes that other major carriers would be willing to provide comparable data concerning the number of subscriber locations they serve over their own local distribution (non-UNE-loop) plant. Although this "data gathering net" will not provide data on every new entrant, it will certainly cover the vast majority of customer locations in a given MSA. Moreover, if the Commission believes more comprehensive data are necessary, as Time Warner (at 26) confirms, the Commission can always require CLECs to provide information (on a confidential basis) as to the number of customer locations they serve.

The Commission should not permit a LEC to satisfy the Phase II trigger on a "class of customer" basis. This option would permit the LEC to accelerate Phase II relief before it has met the relevant threshold in an MSA and allow it to forestall competition directed at

residential customers. Bell Atlantic's further suggestion that a LEC should be accorded region-wide Phase II relief when areas representing 85% of its total revenues have met the Phase II trigger would permit the LEC to obtain relief in noncompetitive areas. For example, under this standard, Bell Atlantic could ostensibly remove its switched services from price caps throughout its region, even though it has met the Phase II trigger only in Maryland, Massachusetts, New Jersey, New York, Pennsylvania and Virginia, without there being any switched services competition in Delaware, the District of Columbia, New Hampshire, Rhode Island, Vermont and West Virginia.

III. CAPACITY-BASED LOCAL SWITCHING CHARGES SHOULD NOT BE ADOPTED.

There is virtually unanimous consensus among the commenters that the Commission should not require LECs to develop capacity-based local switching charges (by considering the aggregate number of trunks switched by the LEC) rather than per-minute-based charges. AT&T at 12-16; Bell Atlantic at 2-5; BellSouth at 8; GTE at 26-34; SBC at 2-3; USTA at 10-15; U S WEST at 8-15; ALTS at 30; C&W USA at 5; Focal/Adelphia at 3; Sprint at 4. The commenters believe that the current rate structure for local switching is reasonably cost-based and no changes to the Part 69 access charges rules are needed.[8] AT&T at 12; BellSouth at 8; USTA at 13. Thus, a capacity-based rate structure for local switching based on the number of trunks connected to end office switches should not be adopted.

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[8] As discussed in the Section IV, *infra,* certain Part 61 price cap changes are required. First, the Commission's proposed "q" factor is needed in order for local switching rates to properly reflect the decline in unit costs resulting from growth in traffic volumes. Second, additional constraints are needed to prevent LECs from undermining the current structure by shifting revenues from their trunk port charge to the per-minute charge. This can be accomplished by establishing a zero upward pricing band limit on the per-minute local switching rate (as was done with the TIC in the local transport restructure).

The Commission suggests that by reflecting peak demand, a capacity-based rate structure may better reflect the manner in which LECs incur local switching costs, because IXCs presumably order capacity based on their peak period traffic. FNPRM, ¶ 211. As the parties explain, however, the number of trunks purchased by an IXC is not necessarily a good proxy for the amount of switching capacity required during peak periods.[9] IXCs order trunks based on their own peak period traffic, while the amount of switching capacity required depends on overall traffic during the LEC's peak period, of which IXC access traffic is only a small portion. AT&T at 15; MCI at 11; Bell Atlantic at 4-5; GTE at 29-30; USTA at 13; U S WEST at 15.

The price cap LECs further confirm the added complexities associated with trunk-based charges. See, e.g., U S WEST at 9-10. Yet, there is no solid evidence that a new structure could be implemented that would be more efficient. Indeed, it is not clear that payments associated with trunk-based charges would differ much from those based on existing per-minute charges. Rather, as AT&T (at 15, 18-19) demonstrated, growth in trunk ports tends to coincide closely with the growth in local switching minutes. Because trunking requirements depend on traffic volumes, trunk ports can be expected to grow at rates that are similar to the growth in minutes-of-use. USTA (at 12) and its expert, Dr. Taylor, show that a "capacity charge based on trunks is really just another form of traffic-sensitive recovery."[10] Ultimately, as Dr. Taylor explains, "any potential gain from a capacity-based rate structure would be offset by implementation costs. The information requirements would be significant." USTA at 13; AT&T at 15; Ad Hoc at 31; ALTS at 30; C&W USA at 5;

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9 Access Charge Reform, First Report and Order, 12 FCC Rcd. 15982, Appendix B, ¶ 47 (1997) ("Access Reform Order").

10 Comments of William E. Taylor, Ph.D. on behalf of United States Telephone Association, October 29, 1999, at 8 ("Taylor").

Focal/Adelphia at 3-4. And, as Wisconsin (at 5) explains, "the theoretical attraction of capacity pricing is heavily burdened with practical problems. . . ." Working with the industry, Wisconsin attempted to "devise a workable capacity-based access charge regime. In the end, . . . implementation proved impossible."

Although strongly opposing a mandatory capacity-based rate structure, the price cap LECs nonetheless contend that they should be permitted to adopt such a structure, if they so choose. Bell Atlantic at 2; BellSouth at 2; GTE at 27, 36; SBC at 2; USTA at 10; U S WEST at 9. As the LECs themselves explain at some length, a capacity-based structure is likely to have substantial and costly implementation issues and is not likely to result in an efficient, cost-causative outcome. In these circumstances, there is simply no rational basis for the Commission to allow the LECs to deviate from the current switching rate structure. Allowing the LECs to develop their own rates structures on an optional basis would increase the complexities of the current access charge scheme with no real benefits. The Commission must ensure that a consistent, nondiscriminatory rate structure is applied by all LECs.

IV. THE PRICE CAP MECHANISM SHOULD BE ADJUSTED TO ACCOUNT FOR GROWTH IN THE TRAFFIC-SENSITIVE AND COMMON LINE BASKETS.

A. The LECs' Contention That The Q Factor And G Factor Adjustments Are Unnecessary Are Wrong.

With the exception of the LECs, the comments support the Commission's proposals to include a q factor in the traffic-sensitive PCI formula and a full g in the common line formula as necessary modifications to its price cap structure. AT&T at 17-23; Ad Hoc at 3-9; MCI at 12-15. The LECs predictably oppose any adjustments for growth in traffic volumes, arguing that the effect of such growth is already fully reflected in the current X-Factor and that the proposed q and g factors would "double count" the effect of productivity gains that are reflected in the measurement of total factor productivity ("TFP") growth used to establish the

X-Factor. Bell Atlantic at 7-8; GTE at 38-40; USTA at 18; U S WEST at 17-19. These objections are without merit because they ignore fundamental weaknesses in the Commission's TFP/X-Factor analysis and framework. Moreover, any concern about possible double counting can be addressed by making a relatively minor adjustment to the X-Factor.

A q factor and a full g factor are necessary because a single X-Factor based on total company productivity growth does not take into account significant differences in cost/productivity trends among different services. As Sprint (at 11) explains, "productivity growth is not uniform: there have been far greater productivity advances in switching – through technological advances in switching equipment – and transport – as a result of the economies of the use of fiber optics in interoffice transmissions – than is the case with the relatively static, largely copper, loop plant." [11]

To some extent the Commission has already reflected fundamental differences in cost and productivity trends among services in price caps by establishing different X-Factors for the LECs' interexchange and interstate access services, including the g/2 term in the common line formula, and targeting price cap reductions to the TIC. However, because the Commission has not adopted an interstate-only X-Factor or service-specific X-Factors that would address these cost/productivity differences directly, additional adjustments to the LECs' PCIs are needed to accommodate these differences among services.[12] If properly

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[11] The CALLS proposal (at Section 3.3) similarly recognizes that costs of local switching and other traffic-sensitive services have declined by more than those associated with common line rates, and accordingly shifts 25% of per-minute local switching revenue to the common line basket and targets X-Factor reductions to the traffic-sensitive elements. In the CALLS proposal, "traffic-sensitive" access charges include monthly charges for dedicated facilities as well as usage-based charges. See Sections 3.1.1 and 3.1.2.

[12] The Commission recently initiated a further proceeding for prescribing the X-Factor in response to a U. S. Court of Appeals remand. See Price Cap Performance Review for Local Exchange Carriers, CC Docket Nos. 94-1 and 96-262, Further Notice of Proposed Rulemaking, FCC 99-345, released November 15, 1999 ("X-Factor Notice").

implemented, the Commission's proposed growth adjustments would reduce those rates that are the most in excess of cost, with price reductions targeted to services that have benefited the most from rising productivity, economies of scale, and resulting declines in unit costs. As AT&T (at 19) showed, inclusion of a q factor in the traffic-sensitive PCI formula would also accommodate differences among LECs, with those LECs that experience the most growth in usage being required to offer additional price reductions.

In opposing the proposed q factor and g factor growth adjustments, the LECs rely on a paper by Dr. William Taylor attached to USTA's comments. Taylor contends that the effect of growth in traffic volumes is already fully reflected in the X-Factor, so that neither the q factor or g factor adjustments are warranted. Taylor argues that because all costs and revenues are captured in the FCC's measurement of TFP, "if interstate minutes of use have grown more rapidly than costs during the historical period, the TFP formula directly captures this growth differential."[13] Adding an adjustment for demand growth to the price cap formula "would effectively 'double-count' a component of historical productivity gains that has already been reflected in the measurement of TFP growth."[14]

Although these arguments may have some validity if the existing X-Factor were properly determined and applicable to interstate access services only, in fact, the current X-Factor based on total company productivity fails to properly reflect the higher productivity growth and declining unit costs associated with local switching and other access services. The relevant factors are these:

1. *The 6.5% X-Factor adopted in 1997 is based on total company TFP growth and is thus heavily influenced by the lower productivity growth of local service.* Because the local service category accounts for nearly 60% of total revenue, it accounts for nearly 60% of the growth in total output in the FCC's TFP analysis and thus has a disproportionate effect

[13] Taylor at 5, 17-21.
[14] Taylor at 5, 21-24.

in determining the X-Factor. The existing X-Factor is more appropriate for regulating local service rates than it is for access services like local switching that have benefited from rapid growth in demand and dramatic technological advances.[15] Nor is the X-Factor, without being supplemented by the g factor, appropriate for regulating the CCL rate which recovers non-traffic-sensitive costs on a per-minute basis.

2. *Use of a single total company X-Factor does not allow for differences in cost/productivity trends among different services.* Given that it is generally acknowledged that significant cost and productivity differences exist among services, it is reasonable that the price cap formulas include additional adjustments to reflect these differences.

3. *Soaring LEC earnings have the unintended consequence of causing the measured X-Factor to decline in the FCC model.* Taylor contends that use of the TFP approach to calculate X "precludes earnings windfalls stemming from the possible misalignment between the manner in which costs are incurred and recovered. . . . If switch costs (inputs) were growing more slowly than the output the switch makes possible, then the TFP analysis would show a more rapid growth in TFP."[16]

   Growth in TFP, however, is only one component of the Commission's X-Factor calculation, which also includes an "input price differential" that is intended to reflect the cost of LEC inputs, including the cost of capital. In the FCC model, LEC earnings – no matter how exorbitant – are included in the cost of capital inputs. For instance, if LEC performance exceeds the productivity target, earnings can be expected to increase. The FCC model, however, treats any increase in earnings as an increase in the "capital rental price" and thus an increase in the cost of LEC inputs. This increase in the input price index has the effect of *offsetting* the rise in productivity when calculating the historical X-Factor.[17] Indeed, the huge surge in LEC operating earnings in 1996 and 1997 caused an increase in the capital rental price that had nothing to do with any increase in the real cost

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15 Because modern electronic switches are essentially large computers, their costs have declined dramatically with the implementation of information-age technology. Productivity growth associated with switching should be comparable to that for other high technology industries. There is evidence that annual TFP growth in the computer and semi-conductor industries has been between 16%-21%. See AT&T Ex Parte, attached to February 21, 1999 letter from Brian W. Masterson to the FCC, CC Dockets Nos. 96-262 and 94-1, Attachment 2 ("Productivity Growth in High Technology Industry" prepared by John R. Norsworthy).

16 Taylor at 20.

17 The Commission has recently acknowledged this conceptual error: ". . . the residual value method tends automatically to define whatever profits or losses the LECs realized during the historical period as increases or decreases in the cost of capital inputs." X-Factor Notice, Appendix A, at 21. The Commission's 1999 Staff TFP Study attempts to correct for this by replacing the 1997 TFP study's cost of capital with a "competitive cost of capital." Id., Appendix B at 45-48.

of LEC inputs.[18] As a result, the Commission's analysis is unable to detect whether the LECs' performance has exceeded or fallen short of the productivity target.[19]

4. *Until 1997, the X-Factor was based largely on the outdated Frentrup-Uretsky study.* From the inception of price caps and until it was revised in May 1997, the X-Factor was based on studies done by the Commission in 1990.[20] The Commission's 1990 and 1995 X-Factor orders both relied extensively on the Frentrup-Uretsky study that examined the trend in switched access prices under rate-of-return regulation from 1984 to 1990 and presumably reflected the reductions in unit costs associated with high demand growth during the period. However, the Frentrup-Uretsky study is nearly 10 years old, and its relevance to current ratemaking issues diminishes with each passing year.

Thus, contrary to the LECs' contentions, neither the Commission's 1997 TFP analysis nor the outdated Frentrup-Uretsky study provide assurance that the various X-Factors in effect have adequately reflected the sharp downward trend in unit costs for switched access services, and for local switching, in particular. Indeed, the Commission itself has recently acknowledged, based on its analysis of potential errors, that "the X-factor calculated in the 1997 Staff TFP study is a significantly downward biased estimator of the actual rate of cost reductions achieved by the price cap LECs."[21] In short, the LECs' assertion that the current X-Factor "fully accounts" for growth is baseless. Moreover, to the extent that the q and g factor adjustments would double count the effect of productivity gains already reflected in the measurement of TFP growth, this concern can be addressed by making a relatively minor adjustment to the X-Factor. See Attachment B.

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18 See AT&T Reply Comments, CC Dockets 96-262 and 94-1 (Nov. 9, 1998), at 19.

19 AT&T is currently reviewing the Commission's recent 1999 TFP Study and Imputed X Study (Appendices B and C of the X-Factor Notice) to determine whether they properly evaluate LEC performance or suffer from the same shortcomings as past studies.

20 J. Christopher Frentrup and Mark I. Uretsky, "Appendix C: A Study of Local Exchange Carrier Post-Divestiture Switched Access Productivity"; see also Thomas C. Spavins, "Appendix D: The Long Term View of the Appropriate Productivity Factor for Interstate Exchange Access" in the LEC Price Cap Order.

21 X-Factor Notice, Appendix A at 31.

Taylor's additional assertion (at 19) that "[s]ince the current growth in minutes per line is less than its growth during the period over which X was estimated, there is more reason to increase the current traffic-sensitive PCI than to decrease it" is just plain wrong. The lower growth in minutes per line that has occurred in recent years results from higher growth in lines rather than reduced growth in minutes, as more and more households have added second or third lines. Growth in the overall demand for LEC services has thus accelerated rather than declined. The high growth in lines, which the LECs have presumably planned for in constructing their loop plant, should result in more productivity growth, not less.

In addition to the shortcomings of the X-Factor discussed above, several other factors have further contributed to widening the gap between rates and costs. Most notably, as a result of the TIC targeting rule adopted by the Commission in the 1997 Access Reform Order, over $400 million worth of X-Factor reductions were targeted to reducing the TIC instead of traffic-sensitive rates in 1997, 1998 and 1999.[22] Consequently, the rates for other services are more inflated than they would have been had the downward impact of the X-Factor operated to control them. Moreover, subsequent to their January 1, 1998 access reform filings, several LECs reduced or eliminated their newly created trunk port charges, making up the revenue by increasing their per-minute local switching charges.[23] As a result, excessive amounts continue to be recovered from the per-minute charges. Finally, current rates under price cap regulation are directly related to the level of rates existing at the inception of price caps. However, these rates are likely to have been inflated because they reflected nonexistent plant and overstated revenue requirements, as identified by the Common Carrier Bureau in its

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22 MCI at 13.

23 FNPRM, ¶ 234.

audits of the RBOCs' hard-wired central office equipment. To the extent that the initial price caps were overstated, price caps have been at excessive levels every year since 1990.[24]

B. A Revenue Per Line Cap Should Be Adopted For The Common Line Basket.

AT&T supports the Commission's proposal (FNPRM, ¶ 233) to cap common line rates on a revenue per line basis as a simple remedy that would hasten the phase out of the CCL charge and result in multiline business PICCs recovering the appropriate amount of revenue to subsidize residential lines.[25] As GTE (at 47) explains, a similar mechanism has been developed as part of the CALLS proposal.

With the predictable exception of the LECs, there is widespread support for the Commission's suggested modifications to the price cap formula for the common line basket. AT&T at 20-26; Ad Hoc at 3-6; GSA at 12-13; MCI at 16-17. LECs, however, oppose increasing the "g/2" factor to a full g, and argue instead that the "g/2" should be eliminated entirely "because the use of either the indirect or direct TFP approach to calculate the X-Factor makes the use of a "g" factor unnecessary and penalizes the price cap LECs." USTA at 19; Bell Atlantic at 9, 15-16; BellSouth at 9; GTE at 37-38; SBC at 3. The LECs also point out that the amount of revenues from the CCL charge is decreasing significantly and most LECs have already eliminated the CCL charge. Id.

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[24] See In the Matter of Continuing Property Records Audits, Orders, ASD File No. 99-22, released March 12, 1999. MCI Comments (CC Docket 99-117), September 23, 1999, at 12-13; AT&T Comments (CC Docket 99-117), September 23, 1999, at 33.

[25] AT&T's proposed revenue per line cap would achieve similar results as: (1) using a full "g" in the common line PCI formula, and (2) adding the requirement that total revenue from SLCs and PICCs be capped on a per line basis. AT&T at 25-26.

Although the g factor does not play as important a role as it did in the past when CCL charges were much higher than currently, the Commission should adopt a full g or a mechanism that caps total common line revenue on a per line basis. Because of the weaknesses inherent in the Commission's TFP/X-Factor methodology as explained in Section IV.A above, the TFP approach to calculate the X-Factor does not properly reflect declining common line costs per-minute that result from the combination of substantial growth in minutes and the recovery of non-traffic-sensitive costs on a per-minute basis.

Moreover, there are several price cap LECs that still obtain significant revenues from the CCL charge.[26] Because minutes have been increasing by more than lines, these LECs tend to realize more growth in revenue over time than LECs with no CCL charges. AT&T at 29. There is no reason why these LECs, which generally have the highest interstate access rates, should enjoy more growth in revenue than those LECs with lower access rates.

All price cap LECs, however, should be required to recompute their common line PCIs assuming that a full g had been in place since the start of price cap regulation. As MCI (at 16) points out, "it is more important for the Commission to correct for the effects of past use of g/2 in the common line PCI formula" than adopt a full g in future tariff filings for those few LECs that still have significant CCL revenue.

As several parties show, it is also necessary to revise the mechanism for calculating multiline business PICCs. AT&T at 20, 23-26; GSA at 11-12; MCI at 18. As the Commission indicated in the FNPRM (¶ 228), the common line formula may create a windfall or shortfall for some LECs as a result of multiline business lines and nonprimary lines

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[26] These LECs include GTE, GSTC, Frontier, Citizens, and Sprint, among others.

growing faster than primary residential and single-line business lines. Bell Atlantic (at 18) points out that the multiline business PICC suppresses demand because business customers are highly price elastic, so that it cannot be assumed "that the local exchange carriers are receiving excess revenues as a result of the subsidy placed on multiline business PICCs."

Regardless of whether the multiline PICC has suppressed demand for LEC serves, the fact is that multiline business lines have grown far more quickly in recent years than single-line business and primary residential lines. GSA (at 12) cites data from the *Statistics of Communications Common Carriers* that show that total LEC multiline business lines increased by 15.4%, whereas primary residence line increased by no more than 7.4% and single-line business lines declined by 8.4%.[27] Bell Atlantic (at 17) itself acknowledges this with its statement that "[t]he actual difference in growth rates is in the single digits." As a result, growth in revenue from multiline PICCs has exceeded growth in the amount of revenue needed to subsidize single-line business and primary residential lines. Using U S WEST as an example, AT&T's analysis indicates that this has provided U S WEST with a windfall of approximately $8.4 million and $33.4 million annually in its 1998 and 1999 annual filings, respectively. See Attachment C.

Furthermore, if Bell Atlantic is concerned about its rates for business customers not being competitive, there is nothing that prevents Bell Atlantic from either charging less than the maximum multiline PICC or reducing other rates paid by business customers. Indeed, one of the basic tenets of the Commission's market-based approach to access reform is the expectation that services "will ultimately be priced at competitive levels even without direct

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[27] These percentages refer to the change in lines from December 31, 1996 to December 31, 1998. Total residence lines increased by 7.4% over the two-year period. The reports do not provide separate figures for primary and nonprimary lines.

regulation of those service prices"[28] and that the "market-based approach will have the effect of making those implicit subsidies subject to being competed away as competitors offer comparable services at prices that do not include the subsidies."[29]

C. A One-Time Adjustment Should Be Made To The Traffic-Sensitive And Common Line Baskets' PCIs.

The Commission acknowledges that the existing per-minute rate structure for local switching provides an incumbent LEC with more revenue whenever per-minute demand increases, regardless of whether the LEC's costs have increased.[30] The Commission also recognizes (FNPRM, ¶ 227) that its access reform rules have not eliminated per-minute CCL charges for some companies as quickly as anticipated, and it previously reached the tentative conclusion that the "per-line" formula" (i.e., with full g) is superior to both the "per-minute formula" and the "50-50 formula" (i.e., with g/2).[31] Accordingly, if the Commission decides to adopt its proposed q factor and full g factor adjustments, it should require the PCIs of the traffic-sensitive and common line baskets to be adjusted, or "reinitialized," as if the new growth adjustments had been in effect since 1991.

For the same reasons that these adjustments are currently needed, they were appropriate in the past, going back to the inception of price cap regulation. As Ad Hoc (at 8-9) points out, "[m]erely applying the new PCI formulation to the current level of the PCI will not suffice, as the current level of the PCI reflects almost ten years of overstated price

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28 Access Reform Order, ¶ 262.

29 Access Reform Order, ¶ 263.

30 See, e.g., Price Cap Performance Review Order For Local Exchange Carriers, CC Docket No. 94-1, 12 FCC Rcd 16642, ¶ 179 (1997) ("1997 Price Cap Performance Review Order"). A similar term could also be added to price cap formula for the trunking basket, based on growth in tandem switching minutes.

31 Price Cap Performance Review Order For Local Exchange Carriers, CC Docket No. 94-1, 10 FCC Rcd 8691, ¶ 271 (1995) (1995 Price Cap Performance Review Order).

changes." For similar reasons, a further one-time adjustment is also needed to remove the impact of multiline business lines having grown at a faster rate than primary residential and single-line business lines since January 1998.

LEC arguments against any form of one-time adjustment boil down to their contention that q factor and g factor adjustments should not be adopted in the first place. Their logic is simply that ". . . there is no 'mistake' that needs to be corrected." See, e.g., Bell Atlantic at 11-12. They maintain that the high and ever-increasing earnings ratios reported for the local switching category are misleading because they are based on regulatory accounting and separations rules that are predicated on arbitrary cost allocations and unrealistic depreciation rates. USTA at 16-17; Bell Atlantic at 11-12.

LEC contentions that returns for local switching or the traffic-sensitive basket are artificially inflated are not convincing. The LECs emphasize, for instance, that increases in local traffic due to Internet usage has shifted costs to the intrastate jurisdiction, causing the earnings for interstate services, particularly in the traffic-sensitive basket, to be artificially inflated. See, e.g., Bell Atlantic at 11, n.5; GTE at 43. However, if Internet usage has caused the fraction of total traffic comprised of interstate access to decline, then it is entirely appropriate that a smaller portion of total costs be allocated to interstate access. The LECs assert that other factors may have artificially contributed to higher earnings for the traffic-sensitive category, such as the transition to dial equipment minutes as an allocator and the change in allocation of general support facilities, yet they provide little explanation and have not quantified the impact of these changes.

At bottom, the LECs allege that proposed one-time adjustments are "an unwarranted throwback to rate-of-return regulation." USTA at 16. This is nonsense. AT&T does not advocate that local switching rates be targeted to yield any specific rate-of-return. However, the dramatic increase in the rate-of-return for the interstate local switching category – from

13% in 1990 to a mind-boggling 52.5% in 1999 – cannot be casually dismissed by asserting that regulatory earnings may be misleading and that higher earnings were intended by price cap regulation.[32] Since the early 1990s, expenses and investments assigned to the local switching category have declined substantially, while revenues grew moderately until 1998.[33] Although it is possible to quibble over some of the underlying cost allocations, the data strongly suggest that the bulk of unit cost reductions have not been reflected in declining rates.

V. THE BLS CHAIN-WEIGHTED INDEX SHOULD BE ADOPTED BUT MORE RADICAL CHANGES TO THE PRICE CAP BASKETS SHOULD NOT BE MADE.

As proposed in the FNPRM, the Commission should adopt the chain-weighted index for the price cap formula. However, it should not make radical structural changes to the price cap baskets.

A. The BLS Chain-Weighted Index Should Be Adopted For Use In The Price Cap Formula.

AT&T agrees with GTE (at 48) and MCI (at 16) that the Commission should adopt the Bureau of Labor Statistics ("BLS") chain-weighted index for use in the PCI formula. FNPRM, ¶ 235. As the Commission correctly notes, the BLS chain index has been used its calculation of a new X-Factor based on total factor productivity. Furthermore, the chain index was not readily available at the time the Commission initially determined that the fixed-weighted GDP-PI was the appropriate measure of inflation.

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32 Rates-of-return are for the RBOCs in aggregate. See AT&T Comments, Attachment A at 1.

33 Expenses and investments for the local switching category in ARMIS are shown in Attachment B of AT&T's Comments.

The adoption of the BLS chain-weighted GDP-PI would eliminate the inconsistency between the calculation of the X-Factor and application of the fixed-weighted GDP-PI in the PCI formula.[34] Moreover, price index theory holds that "for medium and longer term periods when tastes, incomes, technology and availability of resources are likely to change, chain indices provide the only significant economic comparisons. Binary (fixed weight) indices become unrepresentative after only a few years of economic change."[35] By adopting the BLS chain-weighted index, the Commission would both eliminate a source of inconsistency in the price cap mechanism and implement an inflation index that more accurately reflects the changes in the underlying input prices.

B. The Price Cap Basket Structure Should Not Be Modified.

USTA (at 21) asks the Commission to look for ways to decrease the number of price cap baskets to facilitate the market-based approach. It suggests that the Commission consider its earlier proposal to combine the common line, traffic-sensitive and trunking baskets into one pricing basket.[36] U S WEST (at 22-24) proposes to combine the common line and marketing baskets into one basket, move the tandem-switched transport category from trunking basket to traffic-sensitive basket, change the name of the trunking basket to transport basket and abolish service categories in the transport basket. Both USTA's and U S WEST's proposals should be denied because their proposals are beyond the scope of the Commission's request for comments in the FNPRM. The Commission asked whether flat-rated charges and traffic-sensitive charges should be placed in separate baskets and to

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34 FNPRM, ¶ 235.

35 F.G. Forsyth and R.F. Fowler, "The Theory and Practice of Chain Price Index Numbers" Journal of the Statistical Society of America, 144, part 2, at 224 (1981).

36 See Comments of the United States Telephone Association, CC Docket No. 96-262, October 26, 1998, at Attachment F.

specify which service elements would be included in these two baskets if such an alignment of charges were adopted (FNPRM, ¶ 234*), not* whether the price cap basket structure should be radically changed to accommodate a "competitive environment."

In all events, further changes to the price cap basket structure should be deferred pending the development of substantial, demonstrated competition and careful examination of whether additional modifications to the price cap basket structure will protect ratepayer interests. As GTE (at 44) explains, the Commission established separate price cap baskets to reflect the functional separation of elements contemplated by the Part 69 rate structure as well as to minimize the ability of LECs to disadvantage one class of customers vis-a-vis another. It is critical that the price cap structure remains in place until price-constraining competition actually emerges in access markets. Until such competition has firmly established itself in relevant markets in a LEC's territory, the Commission should resist combining baskets or making significant changes to the existing price cap structure that would make it easier for LECs to cross-subsidize potentially competitive access elements with monopoly elements.[37] USTA's and U S WEST's proposals for major changes in the price cap structure are unwarranted, premature and beyond the scope of this proceeding and should be denied.

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[37] USTA's proposal to combine the common line and traffic-sensitive and trunking baskets into one basket would make it possible, for instance, for LECs to reduce rates (*without reducing revenues*) in what is now the trunking basket by raising rates in either the common line or traffic-sensitive basket.

VI. THE COMMENTS CONFIRM THAT THE COMMISSION'S PRO-COMPETITIVE OBJECTIVES WILL BEST BE SERVED BY PERMISSIVE DETARIFFING OF CLEC ACCESS CHARGES.

The FNPRM acknowledged both that under current conditions marketplace forces are insufficient to effectively constrain CLEC access rate levels, and that there is a need for the Commission to implement regulatory solutions that will correct this market failure without intrusive regulatory intervention.[38] In response to that notice, AT&T demonstrated (at 30) that the Commission's dual objectives in this rulemaking can best be satisfied by encouraging CLECs to detariff their rates – and, thus, to negotiate mutually satisfactory contractual arrangements with IXCs that desire to make use of their access services – particularly where the CLECs' charges exceed the corresponding ILEC rates in the same service area. Insofar as CLECs continue to seek to tariff supracompetitive access rates (i.e., in excess of the ILEC levels in the same services areas), however, AT&T showed that those carriers should be required to justify those charges in traditional, non-streamlined tariff review proceedings that comply with the Commission's full panoply of tariff support rules (including, but not limited to, compliance with USOA, separations and Part 69 rate structure requirements), applied to their own individual cost characteristics. As AT&T showed, this dual approach will limit the CLECs' ability to rely upon the "filed rate" doctrine to extort unjustified and excessive access

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[38] See, e.g., FNPRM, ¶ 238:

> "If market conditions fail to constrain CLEC access rates, requiring IXCs to pay access charges set unilaterallly by CLECs is not economically efficient and does not further the goals of the Telecommunications Act of 1996. We are reluctant, however, to regulate rates charged by competitive entrants to the local exchange and exchange access markets and prefer instead to seek a marketplace solution that might constrain CLEC access rates."

rates from IXCs, while creating appropriate market incentives for CLECs to negotiate mutually agreeable access arrangements with IXC customers.[39]

Other commenters likewise recognize the necessity of reintroducing marketplace incentives to control excessive CLEC access rates. In particular, Sprint points out (at 15-17) that a disturbingly large and growing number of CLECs are seeking to impose supracompetitive rates upon IXCs that rely upon them for access. This behavior, as Sprint confirms, reflects the fact that under current market and regulatory conditions CLECs possess powerful de facto bottlenecks that they have every incentive to exploit by overcharging for access.[40] Sprint correctly points out (at 17) that these conditions create perverse incentives for CLECs to compete vigorously for end users – even by offering below-cost retail services to those customers – which they may then subsidize through supracompetitive charges to IXCs, thereby extending the distortive effects of their conduct to the local services market as well.[41]

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39 See AT&T Comments at 30-32. Nothing in AT&T's proposal, moreover, would preclude CLECs whose generally tariffed access rates do not exceed the corresponding ILECs' levels from also negotiating lower, nondiscriminatory charges with their IXC access customers.

40 See J. P. Acton and S. M. Besen, "An Economic Analysis of CLEC Access Pricing" (Charles River Associates, Inc., October 28, 1999), attached to Sprint's Comments. AT&T has also previously demonstrated that in current conditions the markets for both originating and terminating access services are subject to market failures: in the case of originating access, because of geographic rate averaging requirements, and in the case of terminating access because the CLECs' subscriber does not pay for the call. These conditions preclude IXCs from effectively constraining CLEC access rates even to monopoly levels unless the Commission confirms the right of IXCs not to purchase access from CLECs that charge such excessive rates. See Expert Statement of Frederick P. Warren-Boulton in MGC Communications, Inc. v. AT&T Corp., File No. EAD-99-002 (June 7, 1999) ("Warren-Boulton Expert Statement") (Attachment D hereto); see also Expert Testimony of Frederick P. Warren-Boulton in MGC Communications, Inc. v. AT&T Corp., File No. EAD-99-002 (June 28, 1999) ("Warren-Boulton Expert Testimony) (Attachment E hereto).

41 See also Bell Atlantic at 24-25. AT&T has likewise previously demonstrated that the subsidization of CLEC local rates through supracompetitive access charges is economically inefficient and flatly inconsistent with the Commission's well-established policy of reducing barriers to entry into local markets rather than creating additional

(footnote continued on following page)

Not surprisingly, the FNRPM has evoked an outpouring of comments from CLECs and their sympathizers, who deny both that those carriers' access rates are excessive and that IXCs may decline to order and pay for access at such inflated tariffed rates.[42] None of these arguments, however, demonstrates any legal basis for compelling AT&T and other access customers to enter into such arrangements with CLECs involuntarily. Moreover, even to the limited extent that any of these parties acknowledge the serious problem posed by supracompetitive CLEC rates, their comments simply suggest alternatives to current procedures that would do nothing to apply marketplace competitive forces to constrain unreasonable pricing behavior by those carriers.

Specifically, commenters who assert that AT&T is required to purchase CLECs' access services by Section 201(a) of the Communications Act[43] ignore that this statutory provision mandates interconnection only where the Commission first "finds such action necessary or desirable in the public interest."[44] The Commission has issued no directive requiring IXCs even to interconnect with CLECs that seek to charge supra-competitive rates –

(footnote continued from previous page)

market distortions. See Warren-Boulton Expert Statement at 4; Warren-Boulton Expert Testimony at 148-163.

42 A number of ILECs have also submitted comments, apparently based on concerns that the outcome of this proceeding may affect IXCs' current service commitments in their own service areas. However, as AT&T showed in its declaratory ruling petition (at 5 n.4), the proper focus of the Commission's inquiry should be upon CLECs whose charges are currently virtually excluded from regulatory scrutiny, rather than upon incumbent carriers that are already subject to at least some regulation of their ratesetting activities.

43 E.g., MGC at 17-18; Alltel at 5; ALTS at 23-25; CTSI at 7-8; MCC at 3-4; NRTA at 6; RCN at 6-7.

44 See, e.g., Woodlands Telecommunications Corp. v. AT&T, 447 F. Supp. 1261, 1265 (S.D. Tex 1978) ("A carrier's decision whether to interconnect or refuse to interconnect is a matter of business judgment which is not subject to Section 201(a) unless, after a refusal, the FCC directs such interconnection."); Southern Pacific Communications Co. v. AT&T, 556 F. Supp. 82 (D.D.C. 1983), aff'd, 740 F.2d 980 (D.C. Cir. 1984), cert.

(footnote continued on following page)

much less obligating IXCs to purchase access from those carriers at their inflated rates – and no such obligation could be imposed in light of the public interest findings required by Section 201(a). That statute thus offers no support for the commenters' position.[45]

The commenters reliance on Section 251 of the Communications Act[46] is likewise unavailing because that statute merely confers on telecommunications carriers such as AT&T the right to request interconnection in order to purchase another carrier's services or to use that other carrier's facilities.[47] That provision does not entitle CLECs to sell their access services to an IXC that does not desire to purchase their offerings.[48]

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denied, 470 U.S. 1005 (1985) ("a carrier has no duty under the Communications Act to provide interconnection to another carrier").

45 See, e.g., ITT World Communications, Inc., 87 F.C.C.2d 684, 687 (1981) (a carrier is "not obligated by any Commission order to provide requested interconnection . . . is not in violation of § 201(a) for refusal to interconnect"); Application of South Central Bell Co., 2 FCC Rcd 196 (1987) ("Radiofone did not petition this Commission to order that South Central be requested to provide . . . interconnection. . . . Accordingly, South Central cannot be deemed to have violated Section 201(a)").

46 E.g., Allegiance at 5-6; ALTS at 23-25; CTSI at 8.

47 See Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, 11 FCC Rcd 15499, 15991 (¶ 997) (1996) (Section 251(a) imposes a duty on telecommunications carriers "to provide interconnection") (emphasis supplied), aff'd sub nom. Southwestern Bell Tel. Co. v. FCC, 153 F.3d 597 (8th Cir 1998). Section 251(c)(2)(D) further confirms that IXCs have no obligation to purchase access from CLECs; that section imposes a duty on LECs to "interconnect" with requesting carriers and obligates the carrier providing interconnection to charge the requesting carrier "just, reasonable and nondiscriminatory rates."

48 Other arguments raised by the commenters to require IXCs to purchase CLECs' access services are, if anything, even more meritless. For example, those parties that rely on Section 214 (e.g., ALTS at 26; MCC at 6-7; MGC at 19) as a basis for this claim ignore that the Commission has forborne application of this statute to nondominant carriers such as AT&T. Moreover, this provision imposes no obligation on any carrier to extend service into a given area; likewise, an IXC's determination to cease purchasing access from a CLEC does not implicate Section's 214 service discontinuance provisions because an affected CLEC's end users retain the option to continue such service through the ILEC in that service area. MGC's additional claims (at 23-25) that dialing parity or equal access requirements somehow obligate IXCs to order and pay for CLEC access services have been expressly rejected by the Common Carrier Bureau, and MGC has not sought review of those determinations. See MGC Communications, Inc. v. AT&T

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Commenters' additional claims that IXCs are obligated to pay CLECs' exorbitant access charges simply by virtue of the fact that their networks receive traffic from, or terminate traffic to, the CLECs' end users are likewise erroneous.[49] As a threshold matter, AT&T has already demonstrated that the mere fact such traffic transits the IXCs' networks to or from CLECs does not represent a "constructive order" for such access under the Commission's Capital Network and United Artists Payphone decisions unless an IXC affirmatively establishes a network relationship with the CLEC.[50] Moreover, AT&T has also demonstrated that it is not technically feasible without time-consuming and costly development for IXCs such as AT&T to identify and then selectively block calling over their networks from or to end users served by CLECs.[51] The MGC Order (¶ 16 n.32) recognized that it would be "unreasonably burdensome" to require AT&T to develop means of blocking originating access traffic from that CLEC, and rejected any need to implement such blocking in order to avoid becoming liable for MGC's access charges. The record confirms that these same considerations are likewise applicable to terminating access traffic, and requires the Commission to adopt the same result with respect to terminating traffic.

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Corp., File No. EAD-99-002, Memorandum Opinion and Order, DA 99-1395, ¶¶ 9-10 (Com.Car.Bur. July 16, 1999) ("MGC Order").

49 E.g., CCG at 3; CTSI at 9-10; MCC at 4.

50 Capital Network Systems, Inc. (Transmittal No. 1), 6 FCC Rcd 5609 (Com.Car.Bur. 1991), application for review denied, 7 FCC Rcd 8092 (1992), 7 FCC Rcd 8092 (1992), aff'd sub nom. Capital Network System Inc. v. FCC, 28 F.3d 21 (D.C. Cir. 1994) ("Capital Network"); United Artists Payphone Corp. v. New York Telephone Co., 8 FCC Rcd 5563 (1993) ("United Artists Payphone"). See AT&T Reply at 8-12; see also AT&T Answer, filed May 28, 1999, in MGC Communications, inc. v. AT&T Corp., File No. EAD-99-002, ¶¶ 53-76.

51 See Expert Statement for T. Michael Bauer in MGC Communications, Inc. v. AT&T Corp., File No. EAD-99-002 (June 7,1999) ("Bauer Expert Statement") (Attachment F hereto); see also Expert Testimony of T. Michael Bauer in MGC Communications, Inc. v. AT&T Corp., File No. EAD-99-002 (June 28, 1999) ("Bauer Expert Testimony") (Attachment G hereto).

To the limited extent that they even acknowledge the existence of a serious and growing problem with excessive CLEC access rates, the principal "solution" suggested by the CLECs is the adoption by the Commission of "benchmark" rates for those charges that would be deemed presumptively reasonable.[52] Their apparent enthusiasm for this dilatory approach is hardly surprising, since none of the commenters that embraces this process supplies any viable decisionmaking principles upon which the Commission could predicate its selection of such a benchmark. Moreover, none of the commenters suggests that the Commission has at hand – or could readily develop – the factual data on CLEC rates and costs and any appropriate comparable carriers in order to prescribe (and thereafter administer and maintain up-to-date) "benchmark" rate levels against which to measure the reasonableness of those carriers' access charges. In the meanwhile, these CLECs will continue their efforts to assess and collect supracompetitive rates from IXCs that must rely upon those carriers for access.

At bottom, the CLECs' endorsement of this proposal is simply an invitation for the Commission to become embroiled in an immensely contentious, time-consuming and enormously burdensome series of inquiries and rulemakings in an effort to determine through regulatory fiat a "benchmark" for reasonable CLEC access rates to substitute for the judgment of the competitive telecommunications marketplace. Even if the Commission did not already face many more critical demands upon its limited administrative resources, any such initiative would on its face be flatly inconsistent with the market-based approach to access reform to which the Commission has committed itself in this rulemaking.

Alternatively, commenters embrace the FNPRM's tentative suggestion (¶ 253) that the Commission attempt to address abusive CLEC ratesetting practices by requiring those carriers

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[52] E.g., ALTS at 9-15; C&W USA at 3; McLeodUSA at 6; MGC at 26; MCC at 14-16; RCN at 13-15.

to maintain terminating switched access rates at the same level as their originating access rates.[53] As AT&T showed in the declaratory ruling proceeding and again has demonstrated above, CLECs possess powerful bottlenecks for both originating and terminating switched access services. Thus, unless IXCs such as AT&T are permitted to decline to purchase those carriers' access services, in the current market and regulatory environment CLECs face no meaningful constraints against maintaining their access charges at supracompetitive levels (i.e., above even subsidy-laden ILEC rates in the same service area). Accordingly, "linking" the CLECs' terminating rates to their unconstrained originating rates, as described in the FNPRM, is an illusory remedy.

The fictive nature of this "relief" is underscored by AT&T's showing in the declaratory ruling proceeding that most CLECS already maintain identical (or virtually identical) originating and terminating switched access rates.[54] Moreover, while those originating access rates are several times higher than the equivalent originating rates charged by ILECs in the same service territories, AT&T demonstrated that the CLECs' terminating rates are

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53 E.g., MCI at 21; Time Warner at 18-19.

54 See AT&T Reply, Attachment B. Sprint (at 16) also confirms that "nearly all CLECs impose the same rates for originating and terminating traffic."

proportionately even higher than the ILEC terminating access rates in the same locale.[55] Thus, far from providing any panacea, requiring parity between the CLECs' originating and terminating access rates would only further entrench those carriers' ability to mulct their IXC customers of exorbitant access charges.[56]

Finally, CLECs also reflexively assert that resort to the Commission's formal complaint process under Sections 206-208 of the Communications Act (47 US.C. §§ 206-208) should be the sole avenue of relief for AT&T and other IXCs to address CLEC access rates that they consider exorbitant.[57] This claim fails on two grounds. First, AT&T and other IXCs would not have any obligation to resort to the Commission's complaint process to challenge exorbitant CLEC rates, absent a subsisting legally enforceable duty to order access from, and pay access charges to, such entities. The mere existence of the formal complaint process does not establish any such duty on AT&T's part, and as shown above, the CLEC commenters

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55 Id.

56 The Commission should also firmly reject the proposal by some CLECs (e.g., ALTS at 33-34) to reclassify originating 8YY (e.g., 800 and 888) calling as terminating access service. Such reclassification is clearly illogical and unwarranted, because this traffic emanates from (not to) end users served by the CLEC. Although the Commissions' Part 69 rules (which are not binding on CLECs) provide for charging access at the "open" end of 8YY services at the terminating access rate, that ratesetting treatment does not alter the indisputable fact the calls charged at those rates originate from the serving LEC's switching office.
Moreover, reclassification would in all events be illusory, because the CLECs' originating access bottlenecks are, if anything, even more powerful than their de facto locational monopolies for terminating switched access. Many CLECs leverage this market power not only to extort high rates from IXC customers but also to obtain additional streams of traffic (e.g., originating 8YY for which some CLECs offer revenue sharing schemes) upon which to assess their exorbitant access rates. For example, MGC has advertised on its Web site a "partners" program offering economic inducements to aggregators with significant volumes of 8YY traffic to route those calls to IXCs via MGC's network. See Sprint Exhibit 4. AT&T understands that a portion of the supracompetitive "originating access" rate that MGC assesses for that traffic is then remitted to its aggregator "partners."

57 E.g., CoreComm at 7; Cox at 4-5; CTSI at 2; Focal/Adelphia at 9-14; MCI at 21; MCC at 4-5; NRTA at 7; RCN at 8; Time Warner at 19-22.

and their sympathizers have failed to articulate any legally supportable basis for imposing such an obligation on IXCs that object to a CLEC's supracompetitive access charges.

Second, and in all events, resort to the formal complaint process as a method of disciplining CLECs' would be wholly inconsistent with the Commission's market-based approach to implementing access charge reform, and would place unacceptable burdens on the Commission's scarce administrative resources. As the Commission underscored in the Access Reform Order,[58] and again strongly reaffirmed in the FNPRM,[59] the Commission is strongly and irrevocably committed to reliance upon marketplace forces, in lieu of regulatory fiat, as the mechanism for regulating nondominant carriers' rates and charges. Reliance on case-by-case adjudicatory resolution of the permissibility of individual CLECs' access rates is antithetical to – and irreconcilable with – the Commission's firmly stated goal of relying on the marketplace to constrain CLEC rates.

Finally, even if it were not flatly inconsistent with the Commission's pro-competitive policies, reliance on the complaint process as a substitute for marketplace forces would place untenable burdens on the Commission's limited administrative resources. Given the already large and fast-growing number of CLECs, the Commission would likely be confronted with the need to adjudicate scores of formal complaints against CLECs annually, based upon individual evidentiary records relating to each such carrier's rates, costs and practices.[60]

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58 Access Reform Order, ¶¶ 358-364.

59 See FNPRM, ¶ 256 ("We strongly prefer not to intervene in the marketplace . . . unless intervention is necessary to fulfill our statutory obligation to ensure just and reasonable rates"); id., ¶ 238 (noting the Commission's preference "to seek a marketplace solution that might constrain CLEC access rates").

60 Moreover, as AT&T showed in its declaratory ruling proceeding (see AT&T Reply at 13-14), the Commission could not grant meaningful relief to complaining IXCs if it were conclude that the lawfulness of tariffed CLEC rates may only be challenged prospectively, in the same manner that the Commission has "deemed" lawful streamlined

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Moreover, because all such actions would necessarily frontally challenge the lawfulness of a CLEC's tariffed "charge[s], classification[s], regulation[s] or practice[s]," the Commission would be statutorily obligated to resolve all such formal complaints within five months of the date each such complaint is initiated.[61]

Even if the Commission could commit sufficient additional resources to address this immense volume of new adjudicatory proceedings, any such enhancement would clearly represent a serious, and unjustifiable, misapplication of agency resources in light of the other critical telecommunications policy issues with which the Commission is now confronted. Rather than adopt the commenters' proposals, or the other suggestions in its FNPRM, the Commission should instead adopt the alternative proposal described in AT&T's comments, which will effectuate the Commission's pro-competitive objectives without imposing undue regulatory burdens on CLECs, IXCs or the Commission itself.

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access rates filed by ILECs. See Implementation of Section 402(b)(1)(A) of the Telecommunications Act of 1996, 12 FCC Rcd 2170 (1997).

61 See 47 U.S.C. § 208(b)(1); Implementation of the Telecommunications Act of 1996: Amendment of Rules Governing Procedures to Be Followed When Complaints Are Filed Against Common Carriers, 12 FCC Rcd 22487, 22503-504 (¶¶ 8-10) (1997).

CONCLUSION

For the reasons stated above and in AT&T's Comments, the Commission should allow LECs to deaverage their common line rates only once certain prerequisites have been met; allow Phase II pricing flexibility for switched services only upon a showing of substantial competition sufficient to curtail a LEC's market power; adopt the proposed q factor and g factor (revenue per line cap) modifications; make one-time downward adjustments to the traffic-sensitive and common line baskets' PCIs; and require CLECs whose rates exceed the incumbent's to justify those charges on a non-streamlined basis with full cost support or proceed on a detariffed (contractual) basis.

Respectfully submitted,

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